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Microenterprise and U.S. Foreign Assistance

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Summary

Microenterprises – businesses operated by the poorest of entrepreneurs – have been targets of U.S. foreign assistance for many years. Microentrepreneurs face a number of obstacles to improving their productivity and standard of living, including a lack of accounting and managerial skills and an inability to obtain financial services – savings and credit. While more research is needed, existing studies have found positive impacts on business and household income, education, and employment, especially among women, when assistance is provided to give better access to savings and credit. In FY1999, roughly $154 million was used by the Agency for International Development (USAID) to assist microentrepreneurs in U.S. aid recipient countries.

Foreign aid has played a major role in the development of microfinance institutions that have emerged in large numbers since the late 1970s. Many of these institutions seek to operate on business principles, charging a rate of interest that might cover costs. Because the poor cannot provide collateral, these institutions often require entrepreneurs to form solidarity groups to take on each other's obligations. Their repayment rate is often above 97%.

Although many other bilateral and multilateral donors have contributed to the development of microfinance institutions, USAID has been the leader in financing and developing programs supporting microenterprise. Congress has strongly endorsed this effort in appropriation bills, by directing a specific level of funding in the FY1988-1992 period and recommending support in report language thereafter. Some Members collaborated with USAID in the development of a Microenterprise Initiative announced in 1994. In October 2000, the 106th Congress approved the Microenterprise for Self-Reliance Act of 2000, authorizing microenterprise support programs (P.L. 106-309).

In FY1999 more than two thirds of USAID funding for microenterprise went toward technical assistance and capital for microfinance institutions. Fifty-eight percent of such funds supported poor people who received poverty loans – mostly loans in amounts of $300 or less, and 69% of clients were women.

Congress has authorized a $155 million funding level for FY2001 and 2002, but achieving that goal depends in part on the overall foreign aid account as well as amounts made available for economic growth objectives versus other priorities sharing the same pot of funds. Some argue that funds should be dedicated to "poverty lending," i.e., aimed at the very poorest of the poor microentrepreneurs by keeping loan levels low. Others argue that the most positive benefits from microfinance accrue to those near the poverty line, not well below it. A number of challenges face microenterprise implementors, including making programs sustainable while broadening their outreach to the poorest, commercialization of microfinance, use of new technologies, and the impact of crises and HIV/AIDS.

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Introduction

Microenterprises – businesses operated by the poorest of entrepreneurs – have long been an object of U.S. foreign assistance policy and a subject of continuing public and congressional interest. Efforts to assist people to overcome poverty through participation in the private sector appear to have widespread appeal to Americans on all points on the political spectrum. Anecdotal accounts of successful microenterprise assistance programs in the developing countries appear regularly in the media, and efforts have been made—some benefitting from the experience of the U.S. Agency for International Development (USAID)—to replicate these programs in the United States. In close collaboration with Members of Congress of both parties, the Clinton Administration launched a Microenterprise Initiative in mid-1994 to make microenterprise "a prominent part" of USAID's economic growth strategy. Since 1987, Congress has periodically approved legislation supporting microenterprise, and, in October 2000, it enacted a formal authorization of such programs in the "Microenterprise for Self Reliance Act of 2000."

This report looks at the features that characterize microenterprises and at the U.S. foreign assistance programs that support microenterprise development. It examines three issues of potential congressional concern: funding of microenterprise programs, conflicting policy priorities, and the challenges now faced by program implementors.

Microenterprise: Background

What are Microenterprises?

Microenterprises are the very smallest of non-farm businesses, owned and operated by only one person or family, and staffed, in the most generally accepted definition, by ten or fewer employees. Microentrepreneurs are the flower sellers, the carpenters, shopkeepers, bakers, and craftspeople who occupy what economists call the informal sector of the economy—the part of the economy that is not easily captured by economists seeking measurements of production output and tax flows. Microenterprises may be part-time or seasonal income-generating activities, and many are based in the home. Microenterprises are the economy of the poorest working segment of society. Estimates of the numbers of such enterprises vary widely—from one-third to one-half of the world's businesses, perhaps several hundred million.

Obstacles and Solutions to the Growth of Microenterprise

Microentrepreneurs face several impediments to improving their productivity and standard of living – a lack of skills and market access, legal barriers, and an absence of financial services, especially capital. A range of efforts, often assisted by international donors, have been made to overcome these obstacles.

Lack of Skills and Access

Entrepreneurs at the micro level often lack accounting, managerial, marketing, and technical skills that might help them successfully manage and expand their businesses and boost productivity. They may also be unconnected to markets outside their cities or country, and to other business people in the same field. Local organizations and donors have responded to these concerns with an array of training and other "business development services" programs (BDS). Associations of similar businesses have been established to provide training, offer advice, and promote regulatory reform. Networks between businesses, exporters, and importers have helped to expand markets.

Legal Barriers

Microentrepreneurs and the institutions that serve them often encounter laws and regulations that discourage growth and consequent entry into the "formal" sector of the economy. Business license requirements, for example, can take months and multiple forms and visits to government offices. Government restrictions on interest rates have hindered bank lending to microbusiness. Donors have supported research and analysis on government policies affecting microenterprise development, provided policy advisers to governments, and encouraged the advocacy activities of local associations of business people.

Absence of Financial Services

The greatest focus of public attention and donor programs during the past two decades has been the inability of microentrepreneurs to obtain financial services—credit and savings—with which to develop their businesses, by funding larger retail inventory or necessary equipment. Microentrepreneurs rarely possess sufficient collateral to satisfy traditional banks, and they require too small a loan to make the transaction seem profitable to lending institutions. One report suggests that only 2.5% of the world's potential microclients have access to financial services other than money lenders.[1]

In the late 1970s, a number of institutions emerged in different parts of the world whose purpose was to offer the credit that banks would not provide. Today, there are thousands of such institutions serving millions of people.[2] The BRAC Rural Development Program in Bangladesh, for example, claims 2 million borrowers, and the Bank Rakyat Indonesia (BRI) has 2.5 million borrowers and 25 million with savings accounts.

The most well-known of these institutions and still a model for microenterprise credit support operations throughout the world is the Grameen Bank in Bangladesh. It has lent roughly $3 billion to date through 1,128 branch offices. It currently serves 2.4 million active borrowers. As developed during the late 1970s by its founder, Mohammed Yunus, the Grameen Bank possesses several features in common with many, but not all, microenterprise credit institutions. It seeks to operate on business principles, charging an interest rate for its loans as high or higher than commercial banks, in an effort to cover costs.[3] In lieu of collateral, Grameen requires that entrepreneurs form "solidarity groups" of five fellow loan seekers, all of whom take on each others' loans as a collective obligation. The effect is to eliminate frivolous loans and to encourage

[1] "Estimates suggest that microfinance institutions reach about 12.5 million poor people worldwide. Microfinance practitioners say that the global microfinance market exceeds 500 million people." *CGAP Report 2000*, p. 10, Consultative Group to Assist the Poorest, World Bank.

[2] A 1999 survey of 1,065 reporting institutions (of 1,600 approached) found 23.6 million clients. *Countdown 2005*. Microcredit Summit Campaign, Vol. 3, Issue 2-3. July/August 2000. In 1996, a World Bank report estimated outstanding loans at 33 million in a survey of 209 institutions out of its inventory of 900 that have over 1,000 clients and three years of experience. *A Worldwide Inventory of Microfinance Institutions, Sustainable Banking with the Poor*, May 1996.

[3] Some object that donor-assisted programs should charge the poor an unsubsidized interest rate, but the rate is often much lower than other options available to the poor. Local loan sharks often charge more than ten times the bank rate. In addition to helping make the lending institution financially self-sustaining in the long run, a realistic rate of interest gives microentrepreneurs a better sense of what is required of them as businesspeople in terms of determining prices, earning a profit, and keeping records.

timely repayment: many microcredit institutions boast repayment rates above 97%, matching major banks in the formal sector.[4]

There are numerous variations of the microfinance concept. For instance, in place of solidarity groups, many institutions establish a "village banking" system in which perhaps 30 or more people set up their own financial institution, which in turn obtains capital from another source. Credit unions have, for many decades, provided credit as well as savings facilities. Some institutions include business training or a health dimension in their programs. Some serve particular types of entrepreneurs.

Many non-governmental organizations (NGOs), which have made up the vast majority of microfinance institutions, are beginning to diversify and operate in a commercial fashion, providing loans on an individual basis, offering savings accounts, and even expanding to more complex financial services such as insurance. Some are even transforming themselves into licensed, for-profit, financial institutions. Established commercial banks, looking for new markets and impressed by the example of successful microfinance NGOs, are increasingly entering the micro sector.

Impact of Microenterprise Support

Dozens of studies have been undertaken or are underway examining the economic and social impact of microenterprise support programs, the bulk on microfinance. The variability of programs, borrowers, and business and social environments has led to an array of study conclusions that describe varying impacts. For many in the international community, the key impact question is whether (and how) these programs can reduce poverty. The consensus at the moment appears to be that such programs are not a "magic bullet" in the war against poverty, but can be highly useful in combating it.

Most studies suggest that provision of credit to people previously unable to obtain it on reasonable terms and the opportunity to establish savings accounts can have positive ramifications for the poor, especially women.[5] Microfinance often raises borrower income. It may help stimulate growth of the borrower's enterprise, and it may generate new employment, raising the income of others. Increased income may be used to directly benefit the families of entrepreneurs. Studies generally support the view that credit programs promote higher household income and increased family welfare, including improved nutrition and education among children. These social impacts are possibly connected to the fact that the largest proportion of microcredit borrowers are women. Many microfinance institutions target women, and some, like Grameen Bank, now lend exclusively to women due to the positive social impact of such lending practices.

Many microfinance institutions seek to promote social welfare directly, in addition to trying to boost incomes. One approach is to offer savings services, as the Indonesian BRI and others have done with great success.[6] The solidarity groups formed by borrowers offer an opportunity to educate borrowers. Some socially oriented microcredit institutions introduce discussions on

[4] For more on the Grameen Bank, see David Bornstein, *The Price of a Dream*, New York, 1996, Alex Counts, *Give Us Credit*, New York, 1996, and Helen Todd, *Women at the Center: Grameen Bank Borrowers After One Decade*, Boulder, 1996.

[5] General conclusions noted in this section are mostly based on studies carried out under the auspices of USAID's AIMS (Assessing the Impact of Microcredit Services) Project. See AIMS publications in http://www.mip.org.

[6] Access to savings services allows the poor to cover food and other needs during low income periods, prepare for retirement or disability, invest in children's education and housing construction, have an alternative to credit, and get a return on their deposit.

family planning or sanitation; the Grameen Bank provides vaccinations through its groups. Groups have been motivated to organize day care centers and clinics in response to problem-solving discussions.

Donor Support

From the beginning, many microenterprise support institutions have been in large part dependent on outside donors for financial and technical assistance. Funds from bilateral and multilateral donors as well as from private foundations have provided the initial capital for loans, funds to cover operating losses, equipment such as computers to track loans, technical experts to advise on methodology and train staff in banking practices, and instructors to provide training to the microentrepreneurs themselves in basic business accounting, marketing and other skills.

In recent years, there has been a growing commitment to microenterprise by the international donor community. One rough estimate puts donor spending in the period from 1990 to 2000 at $2.6 billion.[7] In June 1995, the World Bank, USAID, the International Fund for Agricultural Development (IFAD), the Asian Development Bank, the African Development Bank, the U.N. Development Program (UNDP), the U.N. Capital Development Fund (UNCDF), and the aid agencies of Canada, Netherlands, and France formed a Consultative Group to Assist the Poorest (CGAP).[8] It promotes microfinance by marshaling resources, setting common criteria, improving research on what works, and fostering donor coordination. Through FY2000, CGAP had received $59 million in funds and commitments for its activities, $44 million of it in grants from the World Bank. It expects to continue operations for the next several years on roughly $10 million each year.[9]

Public Support for Microenterprise

Official government and institution support for microcredit activities, both in the United States and abroad, has been stimulated by apparent widespread support within the development and relief community of NGOs. In February 1997, an international Microcredit Summit, attended by nearly 3,000 people from 1,500 institutions and 137 countries, initiated a campaign to insure that microcredit reaches 100 million of the poorest people by the year 2005. The summit was organized by RESULTS, a hunger-focused lobbying group that has had substantial impact on the congressional microenterprise debate for more than a decade. The on-going campaign that emerged from the Summit has sought to educate U.S. and foreign publics and to exchange information on issues of mutual concern among microenterprise practitioners. The campaign is encouraging microcredit programs to reach the poorest people, to reach women, and to become financially self-sufficient, and have measurable, positive impacts on the lives of its clients.[10]

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[7] CGAP Annual Report 1999, page 18.

[8] Australia, Belgium, Denmark, Finland, Germany, Italy, Japan, Luxembourg, Norway, Sweden, Switzerland, the United Kingdom, the European Commission, the Inter-American Development Bank, the International Labour Office (ILO), and the U.N. Conference on Trade and Development (UNCTAD) have since joined.

[9] CGAP Annual Report 1999 and CGAP Annual Report 2000.

[10] See Microcredit Summit website at http://www.microcreditsummit.org.

U.S. Assistance to Microenterprise

Congress and Microenterprise

Since the mid 1970s, the United States has been a leading donor in financing and developing programs supporting microenterprise. Nevertheless, in 1987 a bipartisan group of Members of Congress, backed largely by charitable private voluntary organizations (PVOs) and RESULTS, began advocating a greatly strengthened microcredit effort. Specifically, they wanted an increase in the amount of funding for the program and an increase in funds used for actual loans rather than training or technical assistance. To insure that funds would benefit the very poorest members of the population—an approach known as "poverty lending"—they called for an increase in numbers of loans under $300 and a redefinition of microenterprise to mean those with 4 or fewer employees (later modified to 10).

Authorizing legislation to accomplish these ends was introduced and adopted by the House in 1987, and, in subsequent years, was adopted in various forms either in the House or Senate without, however, ever becoming law. Congress recommended several of these features in appropriations legislation, at first through a legislative earmark for microenterprise (beginning in FY1988 for $50 million and increased to $75 million from FY1989 to FY1992) and later through program guidelines in both bill and committee report language, a practice which continues to this day.[11]

Renewed congressional and executive branch interest in microenterprise was reflected in the development of a USAID Microenterprise Initiative, formulated with the close cooperation and support of House and Senate members of both parties as well as consultation with the Microenterprise Coalition, a U.S. PVO community advocacy group. With then-USAID Administrator Brian Atwood, these congressional Members signed a Charter outlining goals, principles, and commitments on June 22, 1994. Under the Initiative, USAID committed itself to strengthen USAID's capabilities in microenterprise, to maintain and increase funding, to facilitate work with U.S. PVOs, and to increase its emphasis on reaching women and the very poorest. The Initiative was formally "renewed" in July 1997.

Microenterprise for Self-Reliance Act of 2000

Until the adoption of the Microenterprise for Self Reliance Act of 2000, signed into law as P.L. 106-309 on October 17, 2000, microenterprise development activities had been carried out under USAID's broad enabling legislation, the Foreign Assistance Act of 1961. Through this new specific authorization language, the 106th Congress expressed both its strong support for microenterprise programs as well as its policy preferences with regard to the implementation of those programs.

The legislation adds a new section (sec. 131) to the Foreign Assistance Act authorizing the use of grant assistance for credit, business service, and policy reform activities. It requires that half of all assistance target the very poorest – those living in the bottom fifty percent below the poverty level – in programs that provide financial services with loans (in 1995 dollars) of $1,000 or less in

[11] In their versions of the FY2001 Foreign Operations Appropriations, both House (H.R. 4811) and Senate (S. 2522) bills required that at least half of funds for microenterprise be used for "poverty lending" purposes, defined by the House as loans under $1,000 in Europe, $400 in Latin America, and $300 elsewhere, and by the Senate as loans under $300. The House committee report (H.Rept. 106-720) recommended that microenterprise funding be the same as in FY2000 and a best effort should be made to reach $152 million. The Senate made no funding recommendation. The conference report on H.R. 4811 did not make reference to microenterprise funding.

Europe and Eurasia, $400 or less in Latin America, and $300 or less in the rest of the world, and can cover their costs in a "reasonable" time period. "Poverty assistance" may also be used for "demand-driven" business development programs for clients holding poverty loans. The legislation recommends the continued use of USAID central bureaus, among other things, to provide technical assistance for field missions, and grant assistance to strengthen the development of intermediary institutions. It requires the establishment of a monitoring system to measure goals, such as the extent to which the agency is successful in reaching the poor. It authorizes $155 million for each of FY2001 and FY2002.[12]

The Microenterprise Act also adds a new section 108 that authorizes the provision of loans, guarantees, and training under the Micro and Small Enterprise Development Credit Program at a level of $1.5 million for each of FY2001 and 2002. It amends language (section 111) authorizing assistance to cooperatives to make provision of credit to low-income people and microentrepreneurs a priority. The Foreign Assistance Act is further amended (sec. 132) to authorize up to $5 million for the establishment of a new "United States Microfinance Loan Facility", which would provide loans or guarantees to help microfinance institutions prevent bankruptcy due to the affects of natural disasters, wars, or national financial crises.[13]

The USAID Program

USAID conducts its microenterprise program through multiple grant program spigots—some centrally funded and the others mission-funded—and through two credit programs. In FY1999, $153.5 million was used for microenterprise activities.

Currently, USAID has microenterprise programs in more than 55 countries. In FY1999, 67% of funds went to microenterprise loans and institutional development of microfinance organizations, 28% went to business development services (BDS) for microentrepreneurs, and 5% for policy reform on behalf of both microenterprise development institutions and entrepreneurs. USAID assistance in FY1999 benefitted microfinance institutions serving roughly 4.5 million loan clients, and provided BDS to over 400,000 clients.

Proportions of funding going for poverty lending, to women, and to specific geographic regions have fluctuated from year to year.[14] In FY1999, 58% of USAID assistance to financial institutions went to support people who received "poverty loans" – mostly in amounts of $300 or less ($1,000 or less in Central Europe and the former Soviet Union, $400 in Latin America). In FY1998, 63% met this description; in FY1994, 52%. Women accounted for 69% of all loans in FY1999; 84% the year before, and 61% in FY1994. Of total FY1999 microenterprise funding, Africa accounted for 27% (27% in FY1998), Asia/Near East represented 23% (30%), Europe 17% (14%), and Latin America 28% (23%).

[12] While authorizing legislation establishes programs and policy and may recommend specific funding levels, appropriations legislation allocates resources taking spending constraints into account and may set funding levels at less than those authorized.

[13] In addition to these amendments to the Foreign Assistance Act, the legislation contains freestanding sections including requirement of a report on the most effective methods for increasing access for the poor to microenterprise assistance, a sense of Congress encouraging improved U.S. coordination among the G-7 in support of microenterprise and calling for strengthened UN and MDB micro programs, and a sense of Congress supporting increased microcredit assistance to Mexico.

[14] With regard to poverty lending and gender statistics, the results reflect the variability and imprecision of a reporting system whose universe is tens of thousands of loans provided by hundreds of institutions that received USAID support in that particular year. The figures should be viewed as suggestive.

Table 1. USAID Assistance to Microenterprise

(appropriations and local currency in $ millions)*

FY1988	**$57.80**
FY1989	$78.90
FY1990	$75.50
FY1991	$113.60
FY1992	$126.30
FY1993	$96.00
FY1994	$137.40
FY1995	$133.50
FY1996	$111.40
FY1997	$165.10
FY1998	$138.40
FY1999	$153.50

* Microenterprise funding is derived from appropriations to multiple accounts – development assistance, economic support funds, central Europe (SEED), and former Soviet Union (Freedom Support Act) – and from local currencies obtained from the sale of PL480 food aid and from balance-of-payments support.

Note: FY1990 to FY1992 figures do not include microenterprise activities in East Europe. The totals for those years would be slightly higher if those programs were taken into account. Most figures are estimates made by USAID mission personnel – prior to issue of detailed policy guidance in 1994, judgment was more subjective.

Source: USAID

USAID Centrally Funded Grant Programs

Centrally allocated funds—including from USAID's Office of Microenterprise Development and its Office of Private and Voluntary Cooperation in Washington—accounted for 20% of total microenterprise funding in FY1999.

Office of Microenterprise Development

Since the mid-1970s, an office responsible for microenterprise has funded research, disseminated information on best practices, and provided technical assistance for missions directly undertaking microenterprise support projects. Under the Microenterprise Initiative, the Office of Microenterprise Development stepped up these activities and began to provide its own grants. One grant pool – the Implementation Grant Program – is directed toward groups working with developing country microenterprise finance organizations to enable those organizations to reach higher levels of outreach and financial viability. A grant provided to the Grameen Trust assists other credit organizations replicating Grameen Bank methods. A grant to ACCION established a fund from which equity capital can be provided to NGOs making the transformation to formal financial institutions. A Colombian NGO received a grant to develop a business-training program for its microcredit clients.

Another pool of funds – the PRIME Fund – is for co-financing projects with USAID missions so as to insure that the best mission-based projects are adequately supported. Other Office programs assess the impact of microenterprise services and examine and share the best practices of microenterprise organizations. In FY1999, the Microenterprise Office provided about $12 million in grants, down from $25 million in FY1998, and the lowest amount since FY1994.[15]

Office of Private and Voluntary Cooperation (PVC)

For many years, the Office of Private and Voluntary Cooperation has provided funds directly to U.S. microenterprise support organizations to strengthen their management and technical capacities, and, through them, to help local non-governmental partner organizations in developing countries. Grants in FY1999 enabled nearly half of recipients to offer microenterprise services for the first time. A cooperative development program similarly assists cooperatives, including credit unions, many of which provide microenterprise services to their clients. In FY1999, 21 U.S. PVOs received a total of $8.4 million in funding from this Office for microenterprise activities.

USAID Mission Activity

Nearly four-fifths of USAID support for microenterprise in FY1999 came from the agency's field missions. Each mission targets this activity in order to support its wider strategic development objectives in a country – objectives such as empowerment of women, increasing incomes, and democracy building.

While USAID provides a range of assistance to the microenterprise sector, most funds are used to support the development and strengthening of actual microfinance institutions. One aspect of this work, funded by both USAID/Washington and missions abroad, is the strengthening of U.S.-based intermediary organizations, such as ACCION and Finca, that deal with multiple finance institutions throughout the world. USAID funds helped ACCION develop its methodology for assisting microfinance institutions move toward sustainability, for example by exposing ACCION staff to the successful Indonesian BRI, and by providing capital grants to enable ACCION's affiliate institutions to make their first loans. In 1999, ACCION worked with institutions in 14 Latin American countries which disbursed more than $501 million in loans averaging $580 to more than 452,000 clients and with a repayment rate of 98%.[16] USAID is currently supporting ACCION's expansion into Africa.

One beneficiary of USAID's funds and ACCION's guidance was Bolivia's BancoSol, "the first private commercial bank in the world that caters specifically to microentrepreneurs."[17] USAID provided start up capital to PRODEM, the indigenous PVO that spawned BancoSol in 1992. It also provided technical assistance to help BancoSol set up a savings program. The USAID MSED Program, described below, helped ACCION set up a bridge fund that guarantees loans from commercial banks, providing access to private sector capital. It also guaranteed BancoSol's first issue of CDs on the U.S. market. BancoSol now serves 72,000 clients, more than all other Bolivian banks combined.

In addition to institution building, USAID funds have been used to encourage positive changes in government policy affecting microenterprise. For example, in Bolivia, USAID assisted with the drafting of legislation providing for a new class of specialized financial institution that might assist microentrepreneurs. Elsewhere, it has encouraged the deregulation of small business interest rates, previously set at a level that discouraged the creation of microfinance institutions.

[15] The level is expected to rise to $22.8 million for FY2000.

[16] ACCION website "media kit": http://www.action.org.

[17] See Amy J. Glosser, "The Creation of BancoSol", pp. 229-250, in The New World of Microenterprise Finance, Maria Otero and Elisabeth Rhyne, eds., Kumarian Press, 1994.

USAID business development services include providing training courses in business skills and efforts to link specific microbusiness sectors with larger markets. In Uganda, for example, a USAID-funded organization has introduced new food processing technologies – a peanut grinder, manual oilseed press, and cassava slicer – that significantly enhance the productivity of microentrepreneurs. In South Africa, USAID has helped strengthen an indigenous business development service organization by funding efforts to analyze and streamline the organization and set up satellite service centers in neglected communities.

Micro And Small Enterprise Development Program (MSED)

MSED projects, funded centrally in Washington, and initiated and supported by USAID field missions, target financial institutions, including commercial banks, directly. Begun in FY1994, but with antecedents back to 1983, the MSED employs U.S. government guarantees (and to a lesser extent direct loans) to encourage developing country banks to open lending windows to both small and micro businesses. For FY2001, $1.5 million was appropriated to cover subsidy costs for guarantees which can be made on up to 50% of a loan (at as much as a 20 to 1 ratio of U.S. funds to actual value of guarantees, a small appropriation can leverage considerable resources).[18] With half the risk carried by the United States, indigenous banks are more willing to loan to small and micro businesses. The MSED also employs additional grant funds to train bank managers in this form of lending. Although it has been instrumental in the development of microcredit, the MSED chiefly benefits small business. Of nearly $29 million in outstanding loans (as of September 2000), only 3% went towards loans under $1,000.

For FY2001, USAID had proposed the consolidation of its credit programs, including MSED, into one Development Credit Authority program which would fund its guarantees by drawing on transfers from other accounts, rather than direct appropriations. USAID argued that this would save money on administration and insure that appropriated funds were used only for the most beneficial loans. Congress, however, rejected integration of MSED with other credit programs, partly because of a concern that micro funding would be adversely affected if it had to “compete” with other development objectives.[19] Microcredit programs, however, can now be funded under both MSED and the separate Development Credit Authority program.

Issues for Congress

Funding Levels

For more than a decade, U.S. supporters of microenterprise programs both in and out of Congress have argued for increased funding levels. To insure that sufficient funds were spent on microenterprise programs, Congress, in the foreign operations appropriations, earmarked $50 million in FY1988 and $75 million from FY1989 through FY1992. Under the Microenterprise Initiative, USAID agreed with Members of Congress to provide $130 million in FY1994, $140 million in FY1995, and $135 million for each year from FY1996 to FY2000, levels not always achieved but sometimes surpassed due to use of multiple year obligation authority, availability of local currencies, and fluctuations in appropriated accounts. The Microenterprise for Self-Reliance Act of 2000 authorizes a level of $155 million for each of fiscal years 2001 and 2002.

[18] Another $500,000 went for administrative expenses in FY2001.

[19] During debate on the issue in 2000, USAID staff noted that micro programs could still be protected if Congress directed that a portion of the consolidated program be used for this purpose.

Although pressure to raise spending levels is likely to continue – the PVO-supported Microenterprise Summit in 1997 sought an additional $7.5 billion in donor funding by 2005 (of which $3 billion would be loans from MDBs) – continued increases may be difficult to achieve in view of limited funds and competing priorities. Congressional cuts in foreign aid in the mid-1990s made it difficult for USAID to live up to its microenterprise commitments then, and aid levels would have to rise broadly in the future for microenterprise funding to increase. Popular earmarks favoring objectives such as child survival further limit the amounts available for microenterprise. In the case of Nepal, the need to utilize child survival funds reportedly squeezed out microenterprise development entirely as part of the USAID mission strategy. On the other hand, favoring microenterprise with an appropriation earmark or strong funding recommendation would limit other objectives such as environmental protection and democratization.

Should Congress seek to earmark microenterprise spending in the appropriations bill, it will find it a complicated exercise because funding for this activity comes from numerous spigots – four appropriations accounts and local currencies generated by sales of goods funded under these accounts and PL 480, Title II, programs. This is one reason why, in recent years, appropriators have chosen to recommend target funding levels in report language.

Assistance Strategies and Priorities

Supporters of microenterprise development have varied priorities and objectives. For example, some argue that funds should be dedicated largely for poverty alleviation purposes while others want to focus on approaches that more effectively stimulate economic growth. Some favor funding for microloans rather than business services or policy reform. Such differences in approach are discussed below.

Poverty Lending

"Poverty lending" programs are those aimed at the poorest of microentrepreneurs. Proponents of this approach argue that to reach the very poorest – those in the lowest half of the population living below the poverty level – programs should make relatively small loans, often in amounts of less than $300. The extent to which programs are directed at women is also considered by some a measure of poverty lending. For many years, report language accompanying House and Senate foreign operations bills has recommended that half of microenterprise spending be for poverty lending, and, in its Microenterprise Initiative, USAID agreed to ensure that at least half of its microenterprise lending would go for loans under $300 ($1,000 in Europe) and that women would be the chief beneficiaries of microfinance programs.

The Microenterprise for Self-Reliance Act of 2000 requires that half of all assistance be targeted at the very poorest, but bends to arguments long made by USAID and many microfinance implementors that there is a fundamental problem with the insistence on a $300 average loan level and that a degree of flexibility is needed to address the poor. These critics point out that microenterprises, especially successful ones, move on to incrementally larger loans that will raise the average loan amount provided by microcredit organizations. Further, the greater profits derived from lending to these larger micro and small businesses help microfinance institutions to subsidize more numerous, smaller loans for the poorest – so a mix is recommended by many support organizations. Finally, a $300 average loan level is possibly sufficient for the very poorest in India, but has little utility in Europe and some other parts of the world where the cost of doing business is higher. If the objective is to help people do more than increase their inventory of retail items – such as buying an oven for a bakery or a sewing machine for a tailor shop – then larger sums may be necessary. The Act allows poverty loan levels to rise to $1,000 in Europe and Eurasia, $400 in Latin America, and $300 in the rest of the world.

Some poverty lending advocates are dissatisfied with the level of USAID assistance. They point out that while 58% of USAID microfinance program funding may go to poverty lending, only 40% of total microenterprise development funding (including BDS and policy reform) is used for this purpose. They question the value and cost effectiveness of business development services as a tool to help the poorest as compared to credit, suggesting that there is little evidence as yet of the positive impact of BDS. Further, only 29% of USAID BDS-assisted clients were among the very poor. They believe insufficient effort is being made in Africa, where many of the poorest live, to introduce poverty lending. Only half of microenterprise funding in Africa is for financial programs, and only 63% of that goes to poverty lending. In all, they assert that not enough is being done to make credit assistance available to the very poorest.

The "poverty lending" approach to microfinance is not universally esteemed. Some argue that concentration of funds on the very poorest would miss a large number of potentially productive recipients that also cannot obtain credit, such as larger microenterprises as well as many small businesses. These somewhat larger enterprises have, in the view of many, a better chance of creating employment and achieving "graduation" into the formal sector. Some skeptics suggest that enthusiasm for microenterprise assistance as a solution to poverty is unfounded. They point to research suggesting that the most beneficial results from microcredit accrue to those just below the poverty line, not those well below it.[20] One critic also argues that women "do not necessarily benefit from loans disbursed in their names."[21] Others note that the poorest often lack the education, skills, and confidence to start a viable business. While acknowledging that microfinance alone may not be the solution to world poverty, a USAID expert maintains it does provide a service for which there is a clear demand from the poor.

Loan Programs vs. Other Assistance

Since the 1980s, some have sought to insure that the lion's share of U.S. microenterprise assistance was used to fund the loan programs of microcredit organizations. While this strategy is no longer as strongly argued – the Microcredit Act recognizes the importance of other interventions, such as business services, as ways of helping the poor – there remain disparate views of where assistance funds might best be used. According to some, financial support is not the first preference of many entrepreneurs—it is business training, planning support, and marketing advice. Others suggest that financial services other than credit – savings and insurance – would help alleviate the vulnerability of the poor to job loss, disease, or natural disasters. Still others believe that changes in government economic policies and regulations would have a broader and more dramatic impact on the livelihood of micro entrepreneurs than does credit. USAID currently supports each of these activities, but to a lesser extent than loan activity which accounted for two thirds of FY1999 funding.

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[20] One study notes, "...Microfinance is only one of many possible anti-poverty modalities, but the question of whether it is the best or the most efficient has rarely been investigated. In Bolivia, we find it to be an efficient and low-cost method of reducing poverty (down to about 75% of the poverty line) but a poor and expensive method of reducing extreme poverty. Other approaches, in particular investment in social and physical infrastructure and expansion of the labor market, show more promise in reducing extreme poverty." Paul Mosley, *Microfinance and Poverty: Bolivia Case Study*, p. 4, May 1999.

[21] See Ben Rogaly, "Micro-finance Evangelism, `Destitute Women', and the Hard Selling of a New Anti-Poverty Formula", in *Development in Practice*, Volume 6, Number 2, May 1996. See also, *Microfinance and Poverty: Questioning the Conventional Wisdom*, Hege Gulli, Inter-American Development Bank, 1998; and *Microfinance and Poverty Reduction*, Susan Johnson and Ben Rogaly, Oxfam, 1997.

Central vs. Mission Programs

During the past decade, under the Microenterprise Initiative and through specific report language, Congress has recommended the channeling of more microenterprise funds through central USAID/Washington offices. In response, USAID strengthened and expanded the role of its centrally funded programs, in particular the Office of Microenterprise Development. Centrally allocated funds rose substantially in the mid 1990s, from roughly $13 million in FY1994 to $37 million by FY1998, but dropped to $31 million in FY1999.

Congressional and U.S. interest group support for centrally funded mechanisms was partly based on the fact that funds, particularly those funneled through the Office of Private and Voluntary Cooperation, tend to go directly to U.S. NGOs, such as ACCION, Freedom from Hunger, and Finca. Further, the Office of Microenterprise Development is perceived as having considerable expertise and supporting more "cutting-edge" projects and research into best practices. On the other hand, some suggest that USAID missions are in the best position to identify indigenous, innovative groups in the field.

For supporters of central funding, there may be new reasons to be concerned. The drop-off in funding noted above may represent a lack of commitment to the funding targets for the Microenterprise Office and PVC established in the 1990s. It also reflects a 1998 change in USAID procedures by which the Microenterprise Office no longer had its own pool of funds – all of its funding came from USAID regional bureaus and had to be channeled to projects in those regions.[22] Contributions by the different bureaus have been uneven. In FY1999, more than half of funding came from the Africa Bureau alone. Currently, as a result of the new procedure, the Asia and Europe regions receive few grants from the Microenterprise Office.

New Challenges for Microenterprise Support Programs

As microenterprise programs have spread throughout the world, donor agencies and implementing organizations have moved from the simple introduction of credit programs to a set of related concerns centered on how to make these programs more effective, widespread, and lasting. Future congressional interest may focus on progress on these issues.

Reaching the Poor

Research suggests that current programs do not answer many of the problems of active or potential microentrepreneurs, especially the very poorest.[23] Microenterprise practitioners are exploring various avenues of activity that might lead to provision of more effective services. Among the ideas being discussed are microfinance programs that provide short-term emergency loans; more accessible, non-loan related, savings services; insurance programs; and home improvement and construction financing. New business development services programs could include efforts to establish leasing services; and use of communication technologies, including the Internet.

[22] In FY2001, the Office did receive $3 million of its own funds.

[23] For further discussion, see *Microfinance, Risk Management, and Poverty*, Jennifer Sebstad and Monique Cohen, Assessing the Impact of Microenterprise Services (AIMS) study, Office of Microenterprise Development, USAID, March 2000.

Making Programs Sustainable

A leading question since the introduction of microenterprise credit support programs has been whether any of them would be viable without regular infusions of donor financing. It was thought that micro loan organizations—even charging market rates of interest and with their high incidence of repayment—would be less able than commercial banks to cover their costs because of the voluminous number of small loans involved and the consequent expense of paperwork. These organizations also had enormous difficulty getting funding from private capital markets. USAID has long sought to facilitate sustainability by financing research and testing methodologies that might lead to it.[24]

Although the road to self-sufficiency is difficult – one implementor estimates that, of the thousands of microfinance institutions, only 200 have the capacity to become sustainable – a growing number of microcredit organizations have achieved it. In the USAID 1998 microcredit report, eleven percent of reporting microfinance institutions claimed financial sustainability. In its 1999 report, 42 percent said they had achieved it. ACCION International reports that 14 of its 19 Latin American institutions are financially self-sufficient.[25]

Despite this success, several concerns remain. One is that donors will give insufficient time to helping microfinance organizations reach sustainability. International experience, according to USAID, shows that successful institutions have achieved financial self-sufficiency (defined as covering all administrative costs, loan losses, and financing costs at non-subsidized rates from client revenues) within five to ten years. But some experts think that it could take more, especially in difficult environments like Africa. USAID guidelines, however, say it should take seven years to reach sustainability, leaving some wondering if assistance will be cut-off before organizations are ready.

For those targeting assistance to the poorest of the poor, the achievement of sustainable microfinance is not a completed task. Sustainability is often seen as being at odds with efforts to reach the very poorest. Microfinance institutions have found that a mix of income levels in the loan portfolio helps to generate additional revenue as well as cut costs through economies of scale. How to achieve both sustainability and serve the poorest remains a challenge.

Further, there is much more for donor agencies to do to insure sustainability. One is helping organizations to make linkages with private capital markets, that will supplant donors as a source of funds. As noted above, the MSED and Microenterprise Office grants have been used for this purpose on a number of occasions. Another is helping organizations deal with the exponential growth rates that successful organizations have already experienced and must continue to experience if the large field of microentrepreneurs is to be served and if non-subsidized lending is to be cost-effective. In the view of USAID officials, even financial or technical assistance to the organizations that have achieved full operational sustainability should continue in some cases to help them do something they haven't done yet, such as expand deeper into the lower income levels of the poor or provide a new service, such as insurance.

[24] *Maximizing the Outreach of Microenterprise Finance: An Analysis of Successful Microfinance Programs,* Robert Peck Christen, Elisabeth Rhyne, Robert C. Vogel, and Cressida McKean, USAID Assessment Report No. 10, July 1995.

[25] *Reaching Down and Scaling Up*, USAID Microenterprise Results Reporting for 1999, p.24, September 2000.

Commercialization

As NGOs demonstrate the potential sustainability and profitability of microfinance, commercial banks are increasingly stepping into the field.[26] USAID has facilitated this trend by working on changing the policy and regulatory framework that often discourages bank entry, by providing loan guarantees to make entry financially more attractive, and by offering technical expertise. Some credit commercial banks with introducing new financial services and technological innovations. While the commercialization of microfinance promises to meet the objective of making such services more widespread, it may not solve the problem of reaching the poorest. Perhaps because banks are primarily seeking profitability, they tend to serve the upper reaches of the micro and small entrepreneurs – bank loan sizes tend to be larger than those of NGOs. One impact of commercialization, therefore, may be that NGOs are left with the poorest clients, making it difficult for NGOs to achieve financial sustainability. If commercial banks squeeze out the NGOs, one loss would likely be the social objectives that many NGOs support as adjuncts to microfinance, including literacy and health programs. Another would be the loss of innovative approaches that NGOs have historically brought to this field.

Geographic Challenge

Reaching the poor in some cases is a geographic challenge. Micro programs tend to concentrate in urban areas, because of the ease and cost-effectiveness of serving a dense population. Although USAID microfinance programs in Latin America and Asia have done a good job of helping rural clients, elsewhere rural populations are underserved. Whereas 66% of the population of sub-Saharan Africa lives in rural areas, only 44% of microfinance clients do, in the Near East the figures are 42% and 7% respectively, and in Europe/Eurasia, 33% and 3%. For Africa, in the Seeds of Hope Act of 1998, (P.L. 105-385, sec. 102), Congress directed USAID to use credit assistance to help "small-scale farmers and small rural entrepreneurs". The proportion of rural clients has risen in recent years, and USAID is encouraging the spread of programs to the hinterlands by providing incentives to institutions to expand their operations and by demonstrating new ways of delivering services to rural areas.

New Technologies

New technologies may transform current microenterprise practices. For example, a pilot project in Nigeria is using smart card technology, in which the account is maintained on the card, allowing loan officers and borrowers the security of not having to carry cash, providing better downloadable information to the NGO or bank, and permitting farmers to make payments in excess of what is due in order to build savings. Elsewhere, loan officers are using palm pilots to record transactions. USAID is exploring the use of innovative technologies to make microfinance services more affordable and deliver them more efficiently.

Impact of Crises and HIV/AIDS

Microentrepreneurs and microfinance institutions are particularly vulnerable to the dislocations caused by natural disaster or economic crisis. USAID has sought ways to respond to these problems, including the establishment of a special fund to assist Central American microfinance institutions affected by Hurricane Mitch. In Ecuador, USAID used the MSED program to provide

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[26] See *Microfinance Enters the Marketplace*, Elisabeth Rhyne and Robert Peck Christen, USAID Office of Microenterprise Development; and *Commercial Banks in Microfinance: New Actors in the Microfinance World*, Mayada M. Baydas, Douglas H. Graham, and Liza Valenzuela, August 1997, USAID.

microfinance organizations with "portable guarantees" that enabled them to quickly obtain funds to meet the large drawdown demand on client savings during the 1999 economic crisis there. Recognizing such problems, Congress included language in the Microenterprise Act of 2000 that authorizes creation of a microfinance loan facility that would help institutions avoid bankruptcy in the event of natural or other crises. While the problem faced by most microfinance institutions in these situations is a short-term liquidity crisis, it may not be in the interest of the U.S. assistance program to resolve an actual default caused by the failure of clients to repay their loans. The damage done to the reputation of the institution in such an event could be irreparable, preventing it from ever becoming self-sustaining.[27]

The HIV/AIDS epidemic poses another challenge to microfinance institutions, with loss of staff and clients, and greater loan delinquency, among the possible effects. Policy analysts have begun to consider and test numerous approaches to dealing with these concerns, including allowing a healthy member of a household to replace a sick client, provision of death insurance, and development of pre-paid medical payment programs. As a preventative measure, USAID currently supports the integration of health education with microfinance programs.[28]

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[27] See *Disaster Loan Funds for Microfinance Institutions: A Look at Emerging Experience*, Warren Brown and Geetha Nagarajan, USAID Microenterprise Best Practices Project, October 2000.

[28] See *Discussion Paper: Microfinance and HIV/AIDS*, Joan Parker, USAID Microenterprise Best Practices Project, May 2000.